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PURPOSE. To amend the " *Accounting Manual for Federal Credit Unions*" to provide accounting guidance relative to low-income designated credit unions that establish secondary capital accounts as permitted by an Interim Final Rule for the NCUA Rules and Regulations, §701.34.

BACKGROUND. The NCUA Board approved an Interim Final Rule at the January 25, 1996 Board Meeting which authorized those federally insured credit unions designated as low-income to establish secondary capital accounts. The increased capital is intended to enable those credit unions to support greater lending and improve other financial services for the limited income groups and communities they serve. Certain restrictions are placed on these accounts, foremost among them is that the accounts may be *offered only to organizational investors* not to natural person members or other natural person investors. Other key restrictions are:

- The accounts are not insured by the NCUSIF or any other government entity, and may not be offered as share accounts. They will take the form of subordinated debt.
- The funds in the accounts must be available to cover losses, after reserves and undivided earnings, but prior to liquidation.
- The accounts must have a minimum maturity of 5 years.
- The accounts may not be used as security on other obligations of the account holder.
- The accounts will not "carry over" as secondary capital in the event of merger into a credit union that is not low-income designated.

The Interim Final Rule establishes a declining scale for the capital value of accounts with less than 5 years remaining maturity. All funds, however, will continue to be at risk to cover losses that exceed reserves and undivided earnings. Accounts with remaining maturities of at least:

- 4 years, but less than 5 years are counted as capital at 80 percent of face value;
- 3 years, but less than 4 years are counted as capital at 60 percent of face value;
- 2 years, but less than 3 years are counted as capital at 40 percent of face value;
- 1 year, but less than 2 years are counted as capital at 20 percent of face value; and
- less than one year remaining maturity will be counted as capital at 0 percent of face value.

A disclosure and acknowledgment must be provided and executed by an authorized representative of the account holder. This disclosure is set forth in Appendix A of the Interim Final Rule.

State-chartered, federally insured credit unions may establish these accounts in accordance with the terms and conditions authorized for federal credit unions and to the extent they are not inconsistent with applicable state law, regulation, and accounting requirements.

POLICY. A regulatory accounting position (RAP) has been taken in the Interim Final Rule to establish these accounts and to recognize them as secondary capital. These accounts are subordinated debt and the account holder does not have voting or ownership rights. Credit unions should record the amount of secondary capital in the equity section of the balance sheet, although any secondary capital that has a remaining maturity of less than 5 years will be split into capital and liability components based on the sliding scale in the Interim Final Rule. To be consistent with generally accepted accounting principles (GAAP), the credit union's outside auditor may recognize accounts established as secondary capital as subordinated debt, and for financial statement presentation purposes, may reflect the entire balance in these accounts in the liability section of the balance sheet.

The credit union should record the secondary capital and use the new accounts as set forth in the following examples.

EXAMPLE #1: A low-income designated credit union accepted a secondary capital account of \$100,000 with a 6 year maturity from a non-natural person investor. The account should be recorded:

Debit Credit

Cash (Acct. No. 731) \$100,000

*Uninsured Secondary Capital (Acct. No. 925) \$100,000

*New account

EXAMPLE #2: When the remaining maturity of the above account is between 4 and 5 years the following adjusting entry should be recorded to reflect only 80 percent of the account as secondary capital:

Debit Credit

*Uninsured Secondary Capital (Acct. No. 925) \$20,000

*Subordinated CDCU Debt (Acct. No. 867) \$20,000

*New account

ADDITIONAL INFORMATION. In the event that a low-income credit union has depleted its reserves and undivided earnings and incurs an operating loss, the loss will be distributed pro rata among the current secondary capital account holders. For example, a credit union has 5 secondary capital investors, each depositing \$100,000 for total secondary capital of \$500,000. The credit union incurs an operating loss of \$120,000; each account will be debited for \$24,000. The remaining balance in each account will be \$76,000, with a total remaining secondary capital of \$380,000. A credit union that has funds split between account numbers 925 (Uninsured Secondary Capital) and 867 (Subordinated CDCU Debt) should first absorb any pro rata loss from account 867 (Subordinated CDCU Debt), with any remaining loss carried over to account number 925 (Uninsured Secondary Capital).

If a secondary capital account holder wishes to withdraw the investment at maturity, the credit union must determine losses as of the previous month end and allocate the loss, again on a pro rata basis to all account holders, prior to releasing the funds. Keep in mind that all

funds will continue to be at risk to cover losses that exceed reserves and undivided earnings regardless of their capital values based on their final maturities.

The Interim Final Rule requires that the credit union adopt a written plan for use of the funds in the accounts and subsequent liquidity needs to meet repayment requirements upon maturity. The credit union should consider reasonableness and with risk assessment in mind.

The secondary capital accounts may not be established as share accounts and, therefore, will be considered a form of subordinated debt, in effect a borrowing. In most cases of borrowed funds, the stated interest rate is guaranteed contrary to dividends on share deposits for credit unions which are limited to the amount of funds available from earnings, both current and accumulated. The credit union should consider its ability to meet the interest payment obligation in light of its current and accumulated earnings. Interest payable on these accounts must be accrued at least monthly. The credit union should consider the effect on regular members' dividends when setting the interest rate or index for these accounts.

BORROWING LIMITATION . Section 107(9) of the Federal Credit Union Act limits a credit union's borrowing to 50 percent of its paid-in and unimpaired capital and surplus. The amount held in secondary capital accounts held by low-income credit unions is to be included in total borrowings for purposes of this limitation. Secondary capital accounts, plus any other borrowings by the low-income credit union will not exceed the 50 percent limit.

COMMUNITY DEVELOPMENT REVOLVING LOAN PROGRAM . Part 705 of the NCUA Rules and Regulations addresses the Community Development Revolving Loan Program for Credit Unions. A credit union participating in the program may receive up to \$300,000 in the form of a loan. A matching requirement encourages credit unions to develop a permanent source of *member shares* within one year of loan approval.

Accounts established as secondary capital by low-income designated credit unions may not be used as a source of matching funds for this program. First, secondary capital is not a *member share* and second, the regulation requires that the credit union maintain the increase in the total amount of *share deposits* for the duration of the loan from the program. The preamble to the Interim Final Rule clearly states that these accounts "may not be offered as share accounts."

PUBLIC UNIT AND NONMEMBER ACCOUNTS . The preamble to the Interim Final Rule states that since secondary capital accounts are not share accounts, they are not subject to Section 701.32 limitations.

5300 GUIDANCE . The June 1996 5300 Call Report and Instructions will be changed to accommodate new account numbers for recording and capturing secondary capital data.

If a low-income designated credit union over \$50 million in assets establishes secondary capital accounts prior to March 31, 1996, it should report the amount in "Other Reserves" (Acct. Code 658). If any portion is not considered secondary capital due to maturities less than 5 years, it should be reported under "Other Notes and Interest Payable" (Acct. Code 656C) on the Borrowing Schedule. The credit union should report using the new accounts for the June 1996 report. New accounts set up for secondary capital accounts are not to be used for any other

purpose. These accounts should be left blank unless secondary capital accounts are established.

EFFECTIVE DATE. This Bulletin is effective immediately and will remain in effect until incorporated into the *Accounting Manual for Federal Credit Unions*.

Karl T. Hoyle

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